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SUBJECT: HAS CHINA CHANGED ITS EXCHANGE RATE POLICY?

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¶1. (SBU) Summary. Since December 1, the Chinese renminbi (RMB) has depreciated 0.7 percent against the USD, generating speculation that the government has altered its longstanding policy of gradual appreciation. Senior economic and financial leaders, however, continue to maintain that policy has not changed, but that exchange rate fluctuations must be expected. They also have acknowledged that the exchange rate issue is complicated, requiring a balancing of various social, political, and economic concerns, including how best to assist the distressed export sector. Most analysts expect further appreciation of the RMB against the USD will be limited in the near term. See paragraphs 7-8 for comments. End summary.

¶2. (SBU) The recent slight depreciation of the Chinese renminbi (RMB) against the USD has raised questions about whether China has revised its exchange rate policy. Over the past week (Dec. 1-8), the RMB depreciated 0.7 percent against the USD. More specifically, during the six trading days from Dec. 1-8, the RMB depreciated each day by 0.4-0.5 percent (the band limit) in intra-day; after each day's depreciation, the People's Bank of China (PBOC) set the following day's morning reference rate 0.4-0.5 percent higher. In response, various rumors and speculation have begun to appear: China is delivering a warning to the United States Government in advance of the Strategic Economic Dialogue and/or sending a signal to President-elect Obama (one currency trader claims to have been told by the PBOC that the Dec. 1 depreciation was intended to send a message to the incoming Obama administration), or China wants to reassure its exporters that their government is responsive to their plight.

¶3. (SBU) Officially, the Chinese Government insists there has been no change of policy. At the December 4-5 Strategic Economic Dialogue (SED) meetings, Vice Premier Wang Qishan stated that the United States can rest assured that the Chinese government will not go back on its word (on currency policy). Commerce Minister Chen Deming said the RMB's slight weakening reflected the USD's strength and had been decided by the market. Chen also said China was not counting on the falling value of the RMB to help its exporters. Similarly, a December 8 Hong Kong press report quoted remarks by Wang that the recent RMB depreciation was due to market-led technological adjustment and revision (perhaps referring to investors adjustment of their portfolios following the Chinese central bank's 108 basis point reduction in administered interest rates), and was not a deliberate government intervention.

¶ 4. (SBU) These comments are consistent with those made by other senior economic policy officials over the past two months. On December 3, visiting U.S. Federal Reserve Board Governor Kevin Warsh asked PBOC Vice Governor Yi Gang if the previous four consecutive days of RMB depreciation against the USD meant a change in policy; Yi replied that in the second half of 2008, the RMB-USD rate had been Qbasically stable,Q but the strong USD had caused the RMB to appreciate significantly against other major currencies. Yi told Warsh that the QUnited States should not worryQ and there has been no change in exchange rate policy, and that increasing fluctuations in either direction were Qperfectly normal,Q and to be expected as China moved to a currency policy more reflective of market supply and demand. Yi said China remains committed to the goal of a convertible currency, but in the short-term the rate will remain QbasicallyQ stable.

¶ 5. (SBU) Despite official assurances, ChinaQs exchange rate policy remains a focus of intense internal debate. On November 7, Vice Minister Liu He of the Central Leading Group on Financial and Economic Affairs told TreasuryQs Special Envoy Alan Holmer that the exchange rate is a Qcomplicated issue.Q Officials in eastern provinces, SMEs and workers in the export sector are QangryQ with the central government for letting the RMB rise against the US dollar. Liu said further RMB strengthening against the USD was not possible in the short-term as it would lead to unrest in those sectors. Similarly, on October 20 PBOC Governor Zhou Xiaochuan told Treasury Under Secretary David McCormick that this issue was not simple for ChinaQs top

BEIJING 00004481 002 OF 002

leadership. The State Council felt pressure to signal support for the export sector by limiting appreciation of the RMB. Zhou added that periodic pauses in the pace of RMB appreciation should not be a concern to the U.S. as long as the long-term trajectory remained the same.

¶ 6. Most market analysts expect RMB appreciation against the US dollar to be limited in the near-term. Most, but not all, analysts do not believe this weekQs depreciation signals a fundamental shift in policy towards depreciation, given that they believe Chinese officials continue to support a gradual reduction in ChinaQs large balance of payment surplus; they also believe the government is sensitive to the risks that a depreciation of the RMB, in the context of continued large-scale intervention in foreign currency markets, risks unleashing a protectionist backlash. Another analyst suggests that, regardless of what PBOC intends to do, if the traders think they intend to depreciate the RMB, then it will come under downward pressure.

¶ 7. (SBU) Comment: We agree with most market analysts that this weekQs developments most likely do not represent a fundamental shift in the long-standing policy of gradually appreciating and increasing the volatility of the RMB against the USD, with occasional QreferenceQ to a trade-weighted basket. We interpret the QreferenceQ to a basket as accelerating (slowing) the pace of RMB appreciation during periods of US dollar weakness (strength). We think the most likely reasons for the RMBQs depreciation this week are: 1) the desire of officials of the PeopleQs Bank of China - which only implements and does not determine monetary and exchange rate policies, and unlike the Federal Reserve is not politically independent - to demonstrate that they are sensitive to the difficulties facing Chinese exporters (amid press reports that export growth dropped significantly in November); and 2) investors exiting the Qcarry-tradeQ of shorting the U.S. dollar given narrowing interest rate differentials.

¶ 8. (SBU) Comment, continued. That said, if the U.S. dollar appreciates significantly against other major

currencies or the Chinese authorities perceive a rising risk of deflation, the chances that exchange policy will change in favor of sustained depreciation of the RMB against the U.S. dollar increases significantly. Many Chinese firms face excess capacity in the face of rapidly weakening demand (particularly abroad), and the pass through to inflation of changes in the exchange rate of the RMB to the U.S. dollar is relatively high. Liu He told Federal Reserve Governor Kroszner that inflation is no longer a concern, and that while deflation is not yet a concern, government officials will be watching for signs of this in the coming year.

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